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13 **UNITED STATES BANKRUPTCY COURT**
14 **SOUTHERN DISTRICT OF CALIFORNIA**

15 In re
16 CITIZENS DEVELOPMENT CORP.,
17 Debtor and Debtor in Possession.

18) Case No. 10-15142-LT11

19) Chapter 11

20) **SYMPHONY ASSET POOL X, LLC's**
21) **TRIAL BRIEF REGARDING**
22) **DEBTOR'S MOTION FOR ORDER**
23) **AUTHORIZING AND DIRECTING**
24) **THE SUBSTANTIVE**
25) **CONSOLIDATION OF DEBTOR**
26) **WITH AFFILIATED ENTITIES**

27) **HEARINGS**

28) Date: January 20, 21 & 24, 2011
Place: Courtroom 3

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1 **I. INTRODUCTION.**

2 Symphony Asset Pool X, LLC ("Symphony") is the successor-in-interest to
3 German American Capital Corporation ("GACC"). On November 19, 2010, GACC
4 assigned to Symphony all right, title and interest to the subject loan made to LSM
5 Hotel, LLC ("LSM Hotel"), an affiliated entity of debtor Citizens Development Corp.
6 ("CDC" or "Debtor"). Like GACC, Symphony opposes CDC's Motion for Substantive
7 Consolidation ("Motion").

8 The test for substantive consolidation requires CDC to meet one of two exacting
9 factors: (1) whether creditors dealt with the entities as a single economic unit and did
10 not rely on their separate identity in extending credit; or (2) whether the affairs of the
11 debtor are so entangled that consolidation will benefit all creditors. The case law is
12 clear that the remedy of substantive consolidation should be used "sparingly" and only
13 as a "last resort." Nevertheless, CDC's pleadings make it sound as if mere convenience
14 to the CDC is sufficient to justify substantive consolidation, but that is clearly not the
15 test.

16 CDC has not, and cannot, meet either factor to justify consolidation. Indeed, it is
17 notable that after the last hearings:

- 18 ▪ Symphony discovered that CDC's principal, Matthew DiNofia ("DiNofia"), filed
19 a Cross-Complaint in a state court action against the junior lien holder on the
20 hotel property. DiNofia alleges in that Cross-Complaint that he had made a deal
21 to give back the hotel property to Symphony's predecessor-in-interest. (Trial
22 Exh. "T"). Specifically, DiNofia alleges that "LSM and [DiNofia] agreed to turn
23 over the Hotel to GACC in return for GACC releasing [DiNofia] from their
24 personal guaranty (the "GACC Guaranty") on the GACC Loan." (Trial Exh. "T"
25 at ¶ 23.) How can the financial affairs of the hotel property possibly be
26 "hopelessly scrambled" with the financial affairs of other affiliated entities if
27 LSM Hotel could so readily give up the hotel property to GACC as DiNofia
28 alleges in his Cross-Complaint?

- 1 ■ CDC has since withdrawn its Motion to substantively consolidate its case with
2 affiliated debtor LSM Executive Course, LLC (“LSM Executive Course”). The
3 fact that CDC told this Court that LSM Executive Course *must* be substantively
4 consolidated before (because the financial affairs of those entities were
5 purportedly inextricably intertwined), but now has dropped LSM Executive
6 Course from its Motion speaks volumes as to the veracity of its assertions that
7 substantive consolidation is necessary. If CDC can pick and choose so easily
8 (and drop entities when their lenders make deals with CDC), then the affairs of
9 these entities can hardly be considered “hopelessly scrambled” as CDC had
10 claimed so as to meet the stringent test for substantive consolidation. Substantive
11 consolidation is a “last resort” remedy, and CDC’s actions have clearly shown
12 that such a remedy is not warranted here.
- 13 ■ Symphony has learned that CDC tried to sell the “restaurant property” located at
14 1035 La Bonita Drive as reflected on an advertising flier (Trial Exh. “S”). The
15 fact that CDC sought to sell the restaurant property demonstrates that the
16 financial affairs of these various entities are not so “hopelessly scrambled” with
17 the affairs of other entities so as to merit substantive consolidation.

18 It is readily evident that the purpose of this Motion is not to substantively
19 consolidate the various entities, but rather is a strategic ploy to frustrate and delay the
20 secured real estate lien holders, such as Symphony, in their efforts to realize upon their
21 respective collateral. The Motion is nothing but leverage so that Debtor can either work
22 out deals with these lien holders or by gerrymandering a larger class of unsecured
23 creditors to vote in favor of some kind of unspecified reorganization plan. CDC’s tactic
24 appears to have worked as to some lenders, but the tactic is not grounds for substantive
25 consolidation – it is a misuse of the bankruptcy process and justification for relief from
26 stay.

27 Even if this Motion was not just a strategic ploy by CDC, the facts here do not
28 even come close to warranting substantive consolidation. In brief, Symphony now

1 holds a first priority \$12 million secured loan against the hotel property owned by
2 debtor LSM Hotel. This loan is with one entity, LSM Hotel, not any other debtors or
3 affiliated entities. And the security for the loan is the real and personal property of the
4 hotel. LSM Hotel is presently in bankruptcy (Chapter 11 bankruptcy, Case No. 10-
5 13024-LT11) and Symphony has a Motion for Relief from Stay also set for evidentiary
6 hearing concurrently with this Motion.

7 CDC is the managing member of LSM Hotel. CDC filed bankruptcy after LSM
8 Hotel, which in turn had filed bankruptcy after LSM Executive Course. It is notable
9 that these entities did not file bankruptcy at the same time, thus further demonstrating
10 that they are not hopelessly intertwined as CDC now claims. CDC originally asked this
11 Court to substantively consolidate four estates: (1) CDC, (2) LSM Hotel, (3) LSM
12 Executive Course and (4) non-debtor Country Club, LLC ("Country Club"), which
13 entities CDC collectively calls the "Resort Entities." As noted above, CDC has
14 withdrawn LSM Executive Course from its Motion (and no explanation about the terms
15 of their deal has been provided to date).

16 To justify substantive consolidation, the Ninth Circuit employs a two factor test
17 which the Court in *In re Bonham* adopted and applied to consolidate the debtors in that
18 case. *Bonham* was a rare case where consolidation was appropriate to address debts
19 arising from a ponzi scheme engineered by one individual. It is vastly different than the
20 case here.

21 The first factor of the test for substantive consolidation is: whether creditors
22 dealt with the entities as a single economic unit and did not rely on their separate
23 identity in extending credit. CDC thus must show that creditors dealt with the "Resort
24 Entities" as a single economic unit and did not rely on their separate identity in
25 extending credit. It is abundantly obvious that Symphony and its predecessors-in-
26 interest relied on LSM Hotel individually, and its asset (the hotel), in extending credit –
27 and did not rely on the "Resort Entities" as a "single economic unit." The loan
28 documents speak for themselves.

1 Furthermore, Symphony submits two declarations from officers of the original
2 lender (Pacific Western Bank) together with copies of the actual loan underwriting
3 report and approvals. As noted in those two declarations and the exhibits attached to
4 them, at all times Pacific Western Bank was looking to LSM Hotel and its collateral
5 (the hotel) to repay the loan and at no time did it extend credit based on the credit of
6 other entities.

7 Notably, CDC's Motion references several other lenders that similarly made
8 loans and secured them with first priority trust deeds on other real property. There's
9 little doubt that these lenders knew exactly which entity that they were dealing with and
10 were relying on the assets of that entity, namely the real property security. Indeed,
11 CDC has not listed any of the other lenders as witnesses or listed exhibits concerning
12 those loans. Thus, it is very clear that the major creditors clearly looked to the
13 individual entities, and not to the so-called group of "Resort Entities" when extending
14 credit. Thus, CDC cannot meet its burden on the first test.

15 CDC also can never show the second factor of the test for substantive
16 consolidation: that the assets and liabilities are so "scrambled" that separating them is
17 prohibitive and hurts all creditors. Not only are the material assets and liabilities well
18 known (since they are the loans and the properties that secure them), but the individual
19 "Resort Entities" have already sorted out the finances of debtors LSM Hotel and LSM
20 Executive Course in connection with seeking approval for their respective Cash
21 Collateral Motions in those bankruptcies. As Symphony's predecessors-in-interest
22 pointed out previously in this Court, LSM Hotel supplied three years of itemized
23 income and expense statements for the hotel as part of its Cash Collateral Motion. Such
24 documents are completely at odds with CDC's current position that the assets and
25 liabilities of the "Resort Entities" are hopelessly scrambled.

26 Certainly, the assets and liabilities of LSM Hotel are easily determined because
27 all one needs to look at is the income and expenses of the hotel. Indeed, CDC, LSM
28 Hotel and LSM Executive Course have all filed schedules under oath, and detailed

Operating Reports, that readily break down the revenues, assets and liabilities of these entities. Their financial affairs are certainly not “hopelessly scrambled” in order to meet the test for substantive consolidation. Notably, CDC has not designated any expert to testify that the affairs of these entities are somehow hopelessly scrambled. CDC thus can *never* meet the second factor as to LSM Hotel.

For these reasons, CDC will not be able to meet its burden at trial.

II. OVERVIEW OF MATERIAL FACTS.

A. The Property Securing LSM’s Debt to Symphony.

LSM Hotel owns a single-asset consisting of a 140 room limited service hotel (“Hotel”) located at 1025 La Bonita Drive, San Marcos, California 92078 (“Property”). Trial Exh. “A”; *see also*, Docket No. 75 [Declaration of Joan Kramer (“Kramer Decl.”) at ¶ 2, and Exh. “A” (legal description of property)].

B. The Original Loan and Security Interest.

Symphony is the assignee of GACC which is in turn the assignee of Pacific Western Bank (“PWB”) which was the successor in interest to First National Bank (“FNB”) (for ease of reference PWB and FNB are collectively referred to herein as “Original Lender”). As of June 13, 2006, Original Lender lent to LSM Hotel the principal sum of Eleven Million Three Hundred Fifty Thousand Dollars (\$11,350,000.00) (the “Loan”).

The Loan was memorialized in, among other things, the following documents:

1. Business Loan Agreement dated June 13, 2006 (the “Loan Agreement”). Trial Exh. “B”; *see also*, Docket No. 75 [Kramer Decl., Exh. “B”];
2. Promissory Note dated June 13, 2006 (the “Note”) executed by LSM Hotel in favor of Original Lender. Trial Exh. “C”; *see also*, Docket No. 75 [Kramer Decl., Exh. “C”];
3. Deed of Trust for the Property, recorded in the Official Records of the County of San Diego, State of California, as Instrument No.

- 1 2006-0428346. Trial Exh. "D"; *see also*, Docket No. 75 [*Kramer*
- 2 *Decl.*, Exh. "D"];
- 3 4. Assignment of Rents (the "Assignment") recorded in the Official
- 4 Records of the County of San Diego, State of California as
- 5 Instrument No. 2006-0428347. Trial Exh. "E"; *see also*, Docket No.
- 6 75 [*Kramer Decl.*, Exh. "E"];
- 7 5. Commercial Security Agreement dated June 13, 2006 ("Security
- 8 Agreement") together with a UCC-1. Trial Exh. "F"; *see also*,
- 9 Docket No. 75 [*Kramer Decl.*, Exh. "F"];
- 10 6. Commercial Guarantees (collectively the "Guarantees") dated June
- 11 13, 2006 and March 27, 2009. Trial Exh. "G"; *see also*, Docket No.
- 12 75 [*Kramer Decl.*, Exh. "G"];
- 13 7. Change in Terms Agreement, dated March 27, 2009 (the "Change
- 14 Agreement"). Trial Exh. "H"; *see also*, Docket No. 75 [*Kramer*
- 15 *Decl.*, Exh. "H"];
- 16 8. Forbearance and Modification Agreement dated December 1, 2009
- 17 ("Forbearance Agreement"). Trial Exh. "I"; *see also*, Docket No. 75
- 18 [*Kramer Decl.*, Exh. "I"];
- 19 9. Assignment of Deed of Trust and Lender's Interest in Other
- 20 Documents (the "Loan Assignment"). Trial Exh. "J"; *see also*,
- 21 Docket No. 75 [*Kramer Decl.*, Exh. "J"];
- 22 and,
- 23 10. Letter Agreement dated March 26, 2010 ("Letter Agreement"). Trial
- 24 Exh. "K"; *see also*, Docket No. 75 [*Kramer Decl.*, Exh. "K"].

24 For ease, the Note, the Deed of Trust, the Assignment, the Security Agreement

25 and UCC-1, the Guarantees, the Change Agreement, the Forbearance Agreement, the

26 Loan Assignment, and the Letter Agreement will be collectively referred to as the

27 "Loan Documents." Docket No. 75 [*Kramer Decl.*, ¶¶ 3-6].

C. Symphony has not treated the affiliated entities as being one, and there is No Evidence that its predecessor-in-interest did so.

Symphony purchased the Note on November 19, 2010 and has certainly not treated LSM Hotel as being an indistinguishable part of a "single economic unit" with CDC or its affiliates. Symphony's predecessor-in-interest, GACC, did not do so either. Docket No. 75 [*Kramer Decl.*, ¶¶ 12-15]. In fact, LSM Hotel was created shortly before this loan funded for the purpose of procuring this loan. The loan proceeds were used to pay off an existing loan in excess of \$6 million and to pay the prior owner of the property \$5.5 million. Docket No. 75 [*Kramer Decl.*, ¶ 14]. The Business Loan Agreement makes it crystal clear that GACC's predecessor was looking solely and exclusively to LSM Hotel and to Mr. DiNofia as the guarantor. Indeed, LSM Hotel submitted specific corporate resolution documents that make it clear that GACC's predecessor was looking to LSM Hotel, and not to other "Resort Entities," with respect to obligations on the loan. Trial Exhs. "K," "L," "M," and "N"; *see also*, Docket No. 75 [*Kramer Decl.*, ¶ 14 and Exh. "L"]. CDC was not the borrower under this loan, nor were any of the other affiliated entities.

Symphony concurrently files two declarations from officers of the Original Lender, Robert Borgman and Robert Koering. Mr. Borgman was the President and Chief Executive Officer for the bank at the time it made the Loan to LSM Hotel. Mr. Borgman served on the credit committee that approved the Loan and he unequivocally testifies, among other things, that the Loan "was not approved based on any consideration of the credit or cash flow of entities that may or might have been affiliated with LSM." Borgman Decl., ¶ 6. Mr. Borgman attaches to his declaration a copy of the Loan Approval and Credit Report used by the bank in approving the Loan. Trial Exh. "P."

Mr. Borgman testifies that the loan was to be repayed from cash flow from the hotel operation and the collateral, and not from any other sources. Borgman Decl., ¶ 7. The Loan Approval and Credit Report also bear this out at the section titled

1 “Repayment Sources.” Trial Exh. “P” at p. 2. Mr. Borgman testifies that had the
2 bank “been looking at other sources for repayment, it would have identified those
3 sources as part of the loan approval process and secured the Loan with any such
4 additional potential sources of repayment with appropriate documentation, including
5 but not limited to perfection of a security interest in such potential sources of
6 repayment.” Borgman Decl., ¶ 8. Mr. Borgman further testifies that there was good
7 reason that the bank was only looking to the hotel property and not to other affiliated
8 entities – namely, the fact that “Mr. DiNofia’s other properties, which he owned
9 indirectly through other entities, were highly leveraged.” Borgman Decl., ¶ 9.

10 Mr. Koering was involved in the two loan modifications, which are reflected in
11 Trial Exhibits “H” and “I.” Mr. Koering testifies that at no time during these loan
12 modifications did the bank make a new loan or otherwise extend additional credit to
13 LSM Hotel. Koering Decl., ¶¶ 7 and 15. Mr. Koering unequivocally states that the
14 bank “had already made the Loan and was not extending any additional credit to LSM
15 nor was it looking to affiliates of LSM as potential sources of repayment in
16 conjunction with the two loan modifications.” Koering Decl., ¶ 17. Mr. Koering
17 testifies that the bank relied on the same repayment sources and did not obtain
18 additional collateral in connection with the modifications. Koering Decl., ¶¶ 8, 14 and
19 17. In easing the loan terms, the bank was simply “seeking ways to recoup payment
20 on the Loan that it had already made to LSM.” Koering Decl., ¶ 17. Mr. Koering
21 attaches the two Loan Approval and Credit Reports relating to the two loan
22 modifications, each of which show that the “Repayment Sources” were the hotel
23 revenue and the collateral, and not from any entity affiliated with CDC. Koering
24 Decl., ¶¶ 3-5 and 9-12, and Trial Exhs. “Q” and “R.”

25 In sum, any assertion by CDC that Symphony or its predecessors-in-interest
26 were looking to the credit of entities other than LSM Hotel is completely unfounded.

27
28

D. LSM Hotel Defaulted on the Loan and Filed Bankruptcy On the Eve of the Hearing for Appointment of A Receiver In the State Court Action.

In February 2010 and continuing thereafter, LSM Hotel failed to pay the amounts due under the Loan as provided for in the Forbearance Agreement and other Loan Documents. LSM Hotel did not make any payments to Symphony's predecessor-in-interest, GACC (and has likewise not made any payments to Symphony).

GACC then recorded its Notice of Default on June 30, 2010 and subsequent commenced an action on July 2, 2010 against LSM Hotel and Matthew DiNofia in San Diego County Superior Court (Case No. 37-2010-00056979-CU-OR-NC). The Complaint alleges three causes of action: (1) Judicial Foreclosure, (2) Appointment of a Receiver, and (3) Breach of Guaranty. On the eve of a hearing on GACC's ex parte application for the appointment of a receiver, LSM Hotel filed bankruptcy.

The total due from LSM Hotel as of the bankruptcy filing was \$11,680,082.73. Docket No. 75 [*Kramer Decl.*, ¶ 10]. Default interest continues to accrue at a rate of \$3,443.42 per day (Docket No. 75 [*Kramer Decl.*, ¶ 11]) and amounts to an additional \$616,372.18 owed on the Loan as of the commencement of the evidentiary hearings. Thus, the total due as of January 20, 2011 is at least \$12,296,454.91, not including attorneys' fees and costs.

As reflected in LSM Hotel's Schedule E, LSM Hotel has also failed to pay the first and second installments of 2009-2010 real property taxes, and supplemental taxes and assessments for the Property.

1 **III. ARGUMENT.**

2 **A. Overview of Substantive Consolidation.**

3 **1. The proponent of substantive consolidation bears the burden**
 4 **to justify consolidation by showing that at least one of a two**
 5 **factor test is met.**

6 The Ninth Circuit employs the Second Circuit's test for substantive
 7 consolidation, which test "requires the consideration of two factors: (1) whether
 8 creditors dealt with the entities as a single economic unit and did not rely on their
 9 separate identity in extending credit; or (2) whether the affairs of the debtor are so
 10 entangled that consolidation will benefit all creditors." *In re Bonham*, 229 F.3d 750,
 11 766 (9th Cir. 2000); *see also, In re Owens Corning*, 419 F.3d 195, 211 (3rd Cir. 2005)
 12 (summarizing Second Circuit test as requiring proponent of substantive consolidation to
 13 prove that, "(i) prepetition they disregarded separateness so significantly their creditors
 14 relied on the breakdown of entity borders and treated them as one legal entity, or (ii)
 15 postpetition their assets and liabilities are so scrambled that separating them is
 16 prohibitive and hurts all creditors").

17 "The burden is upon the proponent of a motion for consolidation and is
 18 exacting." *In re Avery*, 377 B.R. 264, 269 (Bankr. D. Alaska 2007), *quoting, Reider v.*
 19 *Fed. Deposit Ins. Corp. (In re Reider)*, 31 F.3d 1102, 1109 (11th Cir. 1994); *see also, In*
 20 *re Owens Corning*, 419 F.3d at 212 ("Proponents of substantive consolidation have the
 21 burden of showing one or the other rationale for consolidation").

22 **2. Substantive Consolidation is a "last resort" remedy to be used**
 23 **"sparingly."**

24 The two factors are extremely difficult to meet as evidenced by the fact that the
 25 courts have declared that it is a remedy to be used sparingly and only as a last resort. *In*
 26 *re Bonham*, 229 F.3d at 767 (explaining that "almost every other court has noted [that
 27 substantive consolidation] should be used 'sparingly'" *citing, In re Flora Mir Candy*
 28 *Corp.*, 432 F.2d 1060, 1062-63 (2d Cir. 1970); *see also, In re Owens Corning*, 419 F.3d

at 209 (“[T]here appears nearly unanimous consensus that [substantive consolidation] is a remedy to be used ‘sparingly’”) *citing, In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).

“Substantive consolidation usually results in, inter alia, pooling the assets of, and claims against, the [consolidated] entities; satisfying liabilities from the resultant common fund; eliminating inter-company claims; and combining the creditors of the two companies for purposes of voting on reorganization plans. *In re Augie/Restivo Baking Co.*, 860 F.2d at 518. Thus, it is no surprise that this extreme remedy is a “last resort.” *In re Owens Corning*, 419 F.3d at 211 (stating that, “Because substantive consolidation is extreme (it may affect profoundly creditors’ rights and recoveries) and imprecise, this ‘rough justice’ remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code)” *parenthesis in original*).¹

B. CDC Cannot Meet Either of the Two Factors for Substantive Consolidation

1. CDC cannot met its burden of showing a prepetition disregard of the separateness of CDC, LSM Hotel or other affiliated entities.

To justify consolidation under the first factor, CDC must show that creditors dealt with the “Resort Entities” as “a single economic unit and did not rely on their separate identity in extending credit.” *In re Bonham*, 229 F.3d at 766. This first factor is based on the consideration that lenders “structure their loans according to their expectations regarding the borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors

¹ CDC’s pursuit of this motion implicitly concedes that in the absence of substantive consolidation and gerrymandering of unsecured creditors, LSM Hotel cannot propose a confirmable plan of reorganization. That concession is not lost on Symphony and it urges the Court once again to grant its pending relief from stay motion at the earliest opportunity.

1 of a less sound debtor compete for the borrower's assets. *Id.*, quoting *In re*
2 *Augie/Restivo*, 860 F.2d at 518-19.

3 The Second Circuit's rationale for the first factor continues and is instructive:

4 Such lenders structure their loans according to their expectations
5 regarding that borrower and do not anticipate either having the assets of a
6 more sound company available in the case of insolvency or having the
7 creditors of a less sound debtor compete for the borrower's assets. Such
8 expectations create significant equities. Moreover, lenders' expectations
9 are central to the calculation of interest rates and other terms of loans,
10 and fulfilling those expectations is therefore important to the efficiency
11 of credit markets. Such efficiency will be undermined by imposing
12 substantive consolidation in circumstances in which creditors believed
13 they were dealing with separate entities.

14 *In re Augie/Restivo Baking Co.*, 860 F.2d at 518-519.

15 Here, CDC can not satisfy this test. What CDC has demonstrated by its
16 pleadings is that CDC can never meet its burden. Specifically, CDC identified
17 creditors of the various "Resort Entities" that looked to the individual companies and
18 their assets when extending loans. In addition to Symphony's Loan (which is
19 discussed further below), CDC's Motion lists other creditors and their loans, each of
20 which are secured by distinct assets. For example:

- 21 ■ Loan from D&A Semi Annual Mortgage Fund III, LC secured by first and
22 second deeds of trust on the "Restaurant" property. (Motion at p. 10, ¶ 9; *see*
23 *also*, Docket No. 56, bankruptcy Schedule D, at p. 54)
- 24 ■ Loan from Telesis Community Credit Union secured by a first deed of trust on
25 the "Recreation Center" property. (Motion at p. 11, ¶ 13; *see also*, Docket No.
26 56, bankruptcy Schedule D, at p. 55.)
- 27 ■ Loan from Pacific West TD Fund II, LP secured by a first deed of trust on the
28 "Lake and Lakefront Land" property. (Motion at p. 12, ¶ 14; *see also*, Docket
No. 56, bankruptcy Schedule D, at p. 55.)
- Loan from Chris DiNofia secured by a first deed of trust on the "Signage
Parcels" property. (Motion at p. 12, ¶ 15; *see also*, Docket No. 56, bankruptcy
Schedule D, at p. 54.)

1 And, although CDC omits mention of it in its papers, there is a loan from
2 Ronald Frazar to debtor LSM Executive Course which loan is secured by a deed of
3 trust on the "Executive Course" property. *see, In Re LSM Executive Course*, Case No.
4 10-07480-LT11 at Docket No. 22 (emergency motion referencing Frazar loan).

5 CDC cannot prove that the above creditors disregarded the corporate structure
6 of the specific entity that that is the subject of their loan so as to create contractual
7 expectations that they were dealing with the four "Resort Entities" as though they
8 were one indistinguishable entity. Given the size of the subject loans, it is
9 inconceivable that the above creditors did not know exactly which entity they were
10 dealing with, and the assets of that entity, when extending credit. Indeed, each of
11 individual lenders secured their loans by deeds of trust, and thus each of these
12 creditors had to know the assets of the entity for that purpose. Symphony incorporates
13 the opposition pleadings filed by Ronald Frazar which demonstrate that there was no
14 confusion by Mr. Frazar as to which entity he was dealing with in extending credit.
15 *See*, Symphony's Request for Judicial Notice.

16 Most importantly, CDC cannot demonstrate, that Symphony or Symphony's
17 predecessor-in-interest ever treated LSM Hotel as part of some sort of single
18 economic entity with the other "Resort Entities". The subject transaction was
19 "Lending 101" – Symphony's predecessor-in-interest lent money to LSM Hotel and
20 obtained a first priority security interest on the hotel (both the real and personal
21 property). The parties documented this Loan in what could be fairly characterized as
22 "typical" loan documents. Trial Exhs. "B" through "F." The Loan was then
23 reaffirmed repeatedly by LSM Hotel. Trial Exhs. "G," "H," "I," and "K."

24 "This kind of lending occurs every business day. To undo this bargain [with
25 substantive consolidation] is a demanding task." *In re Owens Corning*, 419 F.3d at
26 212. The reason: "Creditors who make loans on the basis of the financial status of a
27 separate entity expect to be able to look to the assets of their particular borrower for
28 satisfaction of that loan." *In re Augie/Restivo Baking Co.*, 860 F.2d at 518-519.

1 It is readily apparent that the case of Symphony's Loan to LSM Hotel is far
2 from a situation like the Ninth Circuit had in *Bonham* where consolidation was found
3 to be appropriate. In *Bonham* the Court was dealing with a ponzi scheme in which
4 there was never any business structure or remotely definable separateness of the
5 parties involved in the scheme. In affirming the bankruptcy courts decision to
6 consolidate, the Ninth Circuit commented:

7 The record clearly shows, and the investors do not dispute the bankruptcy
8 court's determination, that Bonham commingled her personal assets with
9 those of WPI and APFC, that there was no clear demarcation between the
affairs of Bonham, WPI and APFC, and that Bonham often commingled
the assets and names of WPI and APFC.

10 *In re Bonham*, 229 F.3d at 767.

11 Here, there is overwhelming (and insurmountable) evidence that Symphony's
12 predecessor looked to the assets of LSM Hotel, namely, the hotel property, when
13 making its Loan to LSM Hotel. Messrs. Borgman and Koering unequivocally state so
14 in their concurrently filed declarations. This asset is not commingled – title to the
15 hotel property is held as a matter of public record by LSM Hotel.

16 CDC nevertheless asserts that a few creditors (mainly small vendors)
17 supposedly viewed the affiliated entities as a "single economic unit." The fact that a
18 few small vendors supposedly had this view is hardly enough to justify substantive
19 consolidation. Symphony has a \$12 million loan and this is plainly the material debt
20 for purposes of the test for substantive consolidation.

21 Moreover, the fact that certain creditors may have invoiced CDC or the "Lake
22 San Marcos Resort" is of no moment. That is no different than if there was a
23 management company in place operating the various entities and the vendor invoiced
24 the management company rather than the underlying entity. It does not justify
25 substantive consolidation.

26 In short, CDC has not, and cannot, meet the first factor so as to justify
27 consolidation.

28

2. CDC has not met its burden of showing that the affairs of the
“Resort Entities” are so entangled that Substantive
Consolidation will benefit all creditors.

To justify substantive consolidation under the second factor, CDC must show that the “affairs of the debtor are so entangled that consolidation will benefit all creditors.” *In re Bonham*, 229 F.3d at 766. Consolidation under this second factor “is justified only where the time and expense necessary even to attempt to unscramble them is so substantial as to threaten the realization of any net assets for all the creditors” or “where no accurate identification and allocation of assets is possible.” *Id.*, quoting *In re Augie/Restivo*, 860 F.2d at 519.

Importantly, this factor requires that consolidation benefit “all creditors,” meaning that CDC must show that consolidation will benefit Symphony. *In re Owens Corning*, 419 F.3d 195, 214-215 (3rd Cir. Del. 2005) (“commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of *every* creditor – that is, when every creditor will benefit from the consolidation” [*emphasis in original*]).

Here, CDC has not met its burden. CDC has not provided any meaningful evidence post-petition of hopeless commingling of the “Resort Entities” assets and liabilities. CDC has not designated any expert to testify that the affairs of the various entities are in any way “hopelessly scrambled,” and yet it is CDC’s burden to show just that.

There is no question which entity owns certain principal assets and which entity has certain material liabilities because CDC has identified which of the four “Resort Entities” owns each of the material assets, *i.e.*, the various real property assets; and, CDC has similarly identified which creditors have loans secured by those assets. These facts are also a matter of public record.

CDC’s claim that the “Resort Entities” affairs are somehow hopelessly scrambled is also belied by the very pleadings that those “Resort Entities” have filed

1 in this Court. Specifically, LSM Hotel has already argued that it can, and has,
2 segregated its finances. LSM Hotel made this argument in dealing with its Cash
3 Collateral Motion in its own case. In fact, LSM Hotel prepared a budget showing its
4 anticipated revenues and estimated expenses in operating the hotel. Moreover, in
5 asking this Court to approve its use of Cash Collateral, LSM Hotel provided *three*
6 *years* of Income and Expense Statements (aka Profit and Loss Statements) for the
7 hotel dating back to January 2007. Those Statements contain line item details of the
8 income and expenditures in operating the hotel. Docket No. 51 (Exhibit "1" to
9 Supplemental Declaration of M. DiNofia, filed 8/24/10). Similarly, debtor LSM
10 Executive Course was able to segregate its finances sufficiently to prepare a budget as
11 part of its Cash Collateral Motion. *See, In re LSM Executive Course*, USBC Southern
12 Dist. Case No. 10-07480-LT11 at docket No. 22 (Exhibit "1" Emergency Motion re
13 Use of Cash Collateral).

14 Furthermore, LSM Hotel and the other debtors filed schedules under oath that
15 specify their assets and liabilities. And, the various debtors have filed detailed
16 operating reports reflecting their individual revenues and costs. Such documents belie
17 any claim that these debtors' financial affairs are hopelessly scrambled so as to meet
18 the test for substantive consolidation.

19 The material assets and liabilities of LSM Hotel are readily apparent by looking
20 at the hotel (the asset) and its operations (which yield its income and expenses). LSM
21 Hotel's affairs are far from scrambled. Just because LSM Hotel outsources its
22 management and shares some employees with other affiliated entities does not even
23 come close to justifying substantive consolidation.

24 Besides, case law is clear that even if LSM Hotel could not precisely account
25 for some of its affairs, that is not sufficient to justify consolidation. "Neither the
26 impossibility of perfection in untangling the affairs of the entities nor the likelihood of
27 some inaccuracies in efforts to do so is sufficient to justify consolidation." *In re*
28 *Owens Corning*, 419 F.3d at 214-215.

1 The *In re Owens Corning* Court found the comments in *In re World Access,*
2 *Inc.*, 301 B.R. 217 (Bankr. N.D. Ill. 2003) instructive on the issue of inter-company
3 accounting and those comments are pertinent here. In that case, the Court noted that
4 the controlling entity “had no uniform guidelines for the recording of intercompany
5 interest charges” and that the debtors failed to “allocate overhead charges amongst
6 themselves.” *Id.* at 234. The Court held, however, that those accounting shortcomings
7 were “merely imperfections in a sophisticated system of accounting records that were
8 conscientiously maintained.” *Id.* at 279. It ultimately concluded that “all the relevant
9 accounting data ... still existed,” that only a “reasonable review to make any
10 necessary adjustments [was] required,” and, thus, that substantive consolidation was
11 not warranted. *Id.*

12 The Third Circuit astutely commented that, “Imperfection in intercompany
13 accounting is assuredly not atypical in large, complex company structures.” *In re*
14 *Owens Corning*, 419 F.3d at 214-215. While the “Resort Entities” are hardly large,
15 complex company structures, imperfection in intercompany accounting among the
16 “Resort Entities” is certainly likely given the inexperienced management. Whatever
17 self-created imperfections may exist, they are certainly not justification for the drastic
18 remedy of consolidation. Rather, they serve to justify granting Symphony’s Motion
19 for Relief from Stay so that Symphony may proceed with having the state court
20 appoint a receiver experienced in operating hotels to take charge of the Property
21 pending Symphony’s foreclosure.

22 What’s more, there is no showing at all that Symphony will benefit from
23 consolidation. Consolidation will not benefit Symphony, but instead will only serve
24 to put higher priority claims of other consolidated entities above the claims of
25 Symphony. Such a result is one of the reasons why the Second Circuit denied
26 consolidation in the landmark case of *In re Augie/Restivo Baking Co.* In that case,
27 secured creditor Union Bank objected to consolidation because it would impair Union
28

Bank's rights and benefit later creditors, including Manufacturers Hanover Trust Company ("MHTC"), who supported consolidation. The Court found that:

The result of substantive consolidation in the instant case would be to make the assets of Augie's available to pay the debts of Augie/Restivo, and to enrich MHTC (whose entire pre-petition loans to Augie/Restivo have been converted to fully-secured post-petition super-priority administrative debt pursuant to the cash collateral stipulations) at the expense of Union. Even if the reorganization and sale remained viable, moreover, there would be no justification for submitting Union to "cram-down" procedures dominated by creditors of Augie/Restivo.

860 F.2d at 521. These same grounds justify denial of the consolidation motion here. LSM Hotel's asset (the hotel) and the revenues from that asset should not be used to pay other creditors, and, Symphony should not have whatever unsecured portion of its loan subordinated to any higher priority claims of other debtors.

Furthermore, Symphony should not be subjected to possible gerrymandering that certainly will occur if it is placed into a much larger pool of debtors. On this point, the Third Circuit in *In re Owens Corning* noted:

substantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan negotiation process (for example, by deeming assets redistributed to negate plan voting rights), nor a "free pass" to spare Debtors or any other group from proving challenges, like fraudulent transfer claims, that are liberally brandished to scare yet are hard to show.

In re Owens Corning, 419 F.3d at 215. Here, it is self-evident that Symphony will have a drastically different perspective towards LSM Hotel than the unsecured creditors of LSM Hotel, CDC and the remaining "Resort Entities." LSM Hotel should not be permitted to use consolidation as a tool to garner support for any reorganization plan (which Symphony contends it cannot achieve).

For these reasons, this Court should deny CDC's Motion.

C. The Cross-Complaint filed by DiNofia in his state court case is fatal to this Motion.

LSM Hotel sought to give up the Hotel to Symphony's predecessor-in-interest (GACC). As revealed in a state court Cross-Complaint filed by CDC's principal,

Matthew DiNofia, LSM Hotel already tried to give the Property back to Symphony's predecessor-in-interest (GACC) right before LSM Hotel filed bankruptcy. DiNofia alleges that this was attempted in the hopes that GACC would release Mr. DiNofia from his personal guaranty. Trial Exh. "T"; *see also*, Symphony's Request for Judicial Notice, Exh. "T". Mr. DiNofia alleges in his Cross-Complaint that:

During the early summer of 2010, as a result of the dramatic upheaval in the real estate market and collapse of the hospitality industry, LSM was no longer able to continue making payments on the terms of the Senior Loan. In an effort to accommodate GACC, LSM and CROSS-COMPLAINANT agreed to turn over the Hotel to GACC in return for GACC releasing CROSS-COMPLAINANT from their personal guaranty (the "GACC Guaranty") on the GACC Loan (the "GACC Settlement").²

Trial Exh. "T"; *see also*, Request for Judicial Notice, Exh. "T", Cross-Complaint at ¶ 23.

The Cross-Complaint filed by DiNofia evidences two critical points: First, how can the financial affairs of the hotel property possibly be "hopelessly scrambled" with the financial affairs of the other debtors if LSM Hotel could readily have given the property to GACC as DiNofia claims in his state court Cross-Complaint. Trial Exh. "T". This fact unequivocally shows that the financial affairs of these entities are not scrambled and can easily be kept as separate and distinct entities (which they are).

Second, the Cross-Complaint reveals the grave conflict of interest that DiNofia has in these bankruptcy proceedings. How can DiNofia be responsible for a plan of reorganization (if there even was a realistic probability of one, which there is not) when it is clear that he is looking out for himself first (i.e., by trying to absolve himself of his personal guaranty) and not looking at the best interests of the LSM Hotel. Nowhere does DiNofia reconcile how he can uphold his fiduciary duties owed to LSM Hotel and CDC with his own personal interests in avoiding personal

² Symphony is informed that there was no settlement and that GACC disputes the allegations that there was a settlement.

1 liabilities. This constitutes a further ground for not allowing substantive consolidation
2 when DiNofia is simply looking out for his own interests above those of the debtors.

3 **D. CDC's Withdrawal of LSM Executive Course from its Substantive**
4 **Consolidation Motion and its efforts to sell the Restaurant Property**
5 **are Fatal to the Motion.**

6 CDC claimed that LSM Executive Course must be substantively consolidated
7 with CDC, LSM Hotel, and non-debtor LSM Country Club because the affairs of all
8 of these entities are somehow hopelessly scrambled. Of course, when it made a deal
9 with LSM Executive Course, suddenly those affairs were not so scrambled after all.
10 The fact that CDC withdrew LSM Executive Course from its motion only after those
11 parties cut a deal speaks volumes on the veracity of CDC's claims in its motion and
12 demonstrates that CDC is willing to say anything when it suits it. Such action plainly
13 shows that this Motion is nothing but an attempt to gain leverage against the secured
14 lenders.

15 Similarly, CDC has argued that the financial affairs of the various "resort"
16 components are so inextricably intertwined so as to justify consolidation, and yet it
17 tried to sell one of those components, the Restaurant Property. Trial Exh. "S." The
18 fact that CDC tried to sell off the Restaurant Property is illustrative that the
19 components of the so-called "resort" are not scrambled at all.

20 The Motion should be denied for these reasons as well.
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Greenwald, Pauly,
Foster & Miller
A Professional
Corporation

1 **IV. CONCLUSION.**

2 CDC can never show the requirements for substantive consolidation at trial, and
3 therefore this Court should deny its Motion. This Court should further grant
4 Symphony's Motion for Relief from Stay.

5 DATED: January 6, 2011.

6 Respectfully submitted,

7 GREENWALD, PAULY, FOSTER & MILLER,
8 A Professional Corporation

9 ANDREW S. PAULY
ANDREW J. HALEY

10 By: /s/ ANDREW S. PAULY
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PROOF OF SERVICE

STATE OF CALIFORNIA, COUNTY OF LOS ANGELES.

I am employed in the County of Los Angeles, State of California. I am over the age of 18 and not a party to the within action; my business address is 1299 Ocean Avenue, Suite 400, Santa Monica, California 90401-1007.

On January 6, 2011, I served the foregoing document described as **SYMPHONY ASSET POOL X, LLC's TRIAL BRIEF REGARDING DEBTOR'S MOTION FOR ORDER AUTHORIZING AND DIRECTING THE SUBSTANTIVE CONSOLIDATION OF DEBTOR WITH AFFILIATED ENTITIES** on the interested parties in this action by placing a true copy thereof enclosed in a sealed envelope addressed to the addressee(s) as follows:

SEE ATTACHED SERVICE LIST

BY MAIL: I caused such envelope to be deposited in the mail at Santa Monica, California. The envelope was mailed with postage thereon fully prepaid. I am readily familiar with the firm's practice of collection and processing correspondence for mailing. It is deposited with the United States Postal Service on that same day in the ordinary course of business.



BY PERSONAL SERVICE: I personally delivered such envelope by hand to the offices of the addressee.



BY FEDERAL EXPRESS: The Federal Express package tracking number for this envelope is _____, and the envelope was sent [mode] for receipt on [day], [date].



BY ELECTRONIC MEANS: A courtesy copy of the above-referenced document was transmitted by ☐ facsimile and/or ☐ e-mail transmission; said transmission was reported as complete and without error.



Executed on January 6, 2011, at Santa Monica, California.



(State) I declare under penalty of perjury under the laws of the State of California that the above is true and correct.



(Federal) I declare under penalty of perjury that I am employed in the office of a member of the bar of this Court at whose direction the service was made.


LESLIE M. RUDOLPH

Greenwald, Pauly,
Foster & Miller
A Professional
Corporation

SERVICE LIST

In re Citizens Development Corp.

United States Bankruptcy Court, Southern District of California

Case No. 10-15142-LT11

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